Flinders Emerging Companies Fund

Quarterly Update: June 2022

Performance (*after all fees and expenses*)	1 Month (%)	3 Months (%)	1 Year (%)	3 Years (% pa)	5 Years (% pa)	Since Inception^ (% pa)
Flinders Emerging Companies Fund *	-12.96	-21.54	-23.64	2.16	7.87	8.02
S&P/ASX Small Ords Accumulation Index	-13.09	-20.39	-19.52	0.38	5.07	7.52
Net Value Added *	**0.13**	**-1.15**	**-4.12**	**1.78**	**2.80**	**0.50**

* Fund performance numbers are unaudited. Final numbers will be available on our website mid-July 2022. ^ Inception date is 30 September 2015. Past performance is no indicator of future performance.

Investment Objective

Exceed S&P/ASX Small Ordinaries Accumulation Index by 3% pa (after-fees) over rolling 3 year periods

Investment Time Frame

5 years

Portfolio Managers

Andrew Mouchacca and Richard Macdougall

Risk Profile

High

Distribution Frequency

Half Yearly

Minimum Investment

$25,000

Fund Size

$129.9m

APIR Code

ETL0449AU

M-Funds Availability

Code FEC01

Responsible Entity

Warakirri Asset Management Ltd

Research Ratings

Lonsec: Recommended
Zenith: Recommended

Platform Availability

Macquarie Wrap, HUB24, Netwealth, uXchange, BT Wrap, BT Panorama, AMP, North, Xplore, MLC Wrap, CFS FirstWrap, Powerwrap, Navigator, IOOF, Praemium

Further Information

www.flindersinvest.com.au

- **Nasty finish**
- **Commodities sharp reversal**
- **Good news is bad news and bad news is worse…**

The S&P/ASX Small Ordinaries Accumulation Index finished 20.4% lower in the June quarter with May and June exceptionally weak. Small resource stocks underperformed industrials significantly – erasing their dominance over the year as recession fears gripped the US market and (as always) spilled over to all others. Small companies badly underperformed large caps (the Small Ords lagging the ASX100 by 9.3%), not helped by its higher weighting to resources but also to consumer discretionary and technology companies that were also heavily sold down.

All US markets took a dive with the S&P500 down 16.4% but it was the Nasdaq with a 22.4% fall for the quarter that set the tone. European markets were less impacted (the UK FTSE only down 4.6%) and China was the only green entry on the sheet, rising 4.5% as it emerged from Covid lockdowns – it copped its whack in the December half 2021 and is still down 24.2% for the financial year.

The sharpest retracement came in commodity markets. A combination of recessionary fears in the US and Europe plus the impact of Covid lockdowns in major Chinese cities saw a rapid unwind of metals, iron ore and some agricultural commodities. Copper fell 20.2% in the quarter, nickel 30.8% and zinc 23.7%. Iron ore came back 19.9% and energy prices continued to rise. WTI oil was up 4.5% and once again, coal prices defied gravity rising 46% over the quarter and 198% for the financial year – by far, the highest ever recorded prices. Shelter was difficult to find. The gold price held up reasonably well during the quarter, it peeled off toward the end of June to be down 7.5% but the gold mining equities were hurt by higher costs of production due to energy and labour increases.

At a domestic macro level, rising inflation and rising interest rates was the feature of the quarter with increasing expectation of a consumer slowdown, falling housing prices and contracting business activity. While only modest signs of these currently occurring, rising rates will begin to have a greater impact in coming months. The forthcoming 2022 financial year profit results shouldn't hold too many surprises in themselves but comments on current trading conditions may. Earnings forecasts have remained solid for some time but are now coming back – especially in consumer facing companies such as specialty retailers, but we shouldn't forget that many of these companies had to endure significant lockdowns in the December half 2021.

Smaller companies have been marked down significantly and we feel that much of the risk to earnings has already been priced into almost all sectors be they cyclical, financial, technology, consumer or resource based.

We remain focussed on holding a portfolio of companies that are well run, have above market growth moving into 2023 and are at a discount to market. Both the growth and the valuation discount are now compelling.

Performance Review

The Fund returned -21.54% in the June quarter, -1.15% below the benchmark return of -20.39%.

Key Contributors: While there was plenty of red on the performance sheet this quarter, at least there were a few bright lights. There were a small number of downgrades to profit estimates but in general, the portfolio (as did the market) de-rated significantly and is now at a very large discount to its aggregate valuation both in an absolute sense and also relative to the small cap index.

Domestic gas producer, **Beach Energy (+10.9%)** benefitted from higher global energy prices but particularly Australian east coast gas prices. With little excess gas available from the Queensland LNG export industry and a number of coal fired electricity generators temporarily out of action, there was a sudden shortage and the price spiked. So much so that the Government and regulator had to step in and create a cap on pricing. While the situation is easing, the price remains high and unless the oil price retreats substantially, it will do so for some time.

Invoice lending and equipment finance company, **Earlypay (+2.1%)** managed to post a positive quarter as its core lending businesses continued to grow strongly. Earlypay has been a beneficiary of increased demand for credit by small to medium businesses. Banks continue to withdraw from the business market and invoice finance is a growing product for companies to manage expansion and working capital requirements. Earlypay also has market leading technology which is seeing it win market share. It is a high returning company with low credit risk – a good place in the current environment.

Agricultural services company, **Elders (-3.2%)** held up well over the quarter, as it has for the past year. The company has been expanding both its retail and supplies network and capitalising on the increased volumes of farm inputs due to helpful weather conditions. Its agency businesses (livestock, wool and real estate) have also seen the benefit of solid prices. Wet weather, full catchments and elevated agricultural commodity prices will underpin healthy demand at least for another two years and further expansion into under-represented parts of the industry will also help drive profit growth.

Our position in electronic products developer, **Codan (-4.9%)** helped relative performance over the quarter. While the company's share price has been weak over the year, during the quarter they hosted an investor day, guided to profits for the 2022 financial year in line with expectations, and confirmed the progress with their US based communications acquisitions. With its high returns and strong balance sheet, we continue to see a bright future for the company.

Key Detractors: Digital payments and gift card provider, **EML Payments (-59.0%)** fell sharply mid-quarter following a downgrade to earnings forecasts and still no resolution with their European regulator investigation into the company's compliance capability and internal processes. While the regulatory issues relate to an acquired business, it is still hindering their ability to grow in those markets – and has sharply increased their cost base in Europe. A weak board and poor recent communication with investors has not helped perception. While their core businesses are growing well and increased global interest rates help their bottom line, the company remains in the sin-bin until the regulatory issues are resolved. Also continuing to fare poorly was women's plus-sized clothing retailer, **City Chic Collective (-46.2%)**. A combination of fears of a recession hitting discretionary spending, increased inventory levels, and increased costs in both its physical and online stores has sapped investor confidence. While all valid fears, it ignores the fact that the company has increased market share, controlled costs and managed inventory well in recent years. We feel the de-rating of the company has been overdone.

Our gold mining holdings, **Silver Lake Resources (-43.7%)** and **Ramelius Resources (-39.6%)** suffered during the quarter despite a relatively modest 7.5% fall in the gold price. It was all about costs. Mining costs have jumped significantly over the quarter – some of it transitory and some more sticky. Energy costs (diesel and gas) are likely to remain elevated for most of this year but labour interruptions due to Covid will ease. Both companies have significant cash reserves, are growing production and at the current AUD gold price (unchanged over the quarter) their margins remain high. Plus, they are paying dividends (Ramelius) and undertaking capital management initiatives (buy back from Silver Lake) – rather unusual for Australian gold companies!

Portfolio Activity

Exits: Early in the quarter we completed the selling of **Liberty Financial (LFG)**. While the company has been growing its non-mortgage business well and holding interest margins in mortgage lending, volume growth has been falling. The company should have been benefitting from the shift back to variable rate lending from fixed rate (non-banks lenders find it difficult to compete on price in fixed), competition in variable has been intense. Consequently, its growth profile has declined and with it, our valuation on the company and we exited the stock.

Also sold was mining contractor, **Macmahon Holdings (MAH)**. While its valuation was undemanding, concerns on cost increases in the Western Australian mining industry (diesel, staffing, equipment etc.) came to the fore in the quarter. The company is able to pass on some of its cost increases, but not all. And although Macmahon has won numerous contracts over the past year or so, the high capital cost of mobilising and equipping for production increased the financial risk profile.

And lastly, we exited homewares retailer **Adairs (ADH)**. Interest rate rises, falling consumer confidence, a looming recession are all likely to temper revenue growth. Cost growth is also an increasing issue with logistics and transport costs increasing and Covid is still impacting staffing in their stores. We felt the risk to earnings had risen substantially and sold out of the stock.

Additions: Given the slowing economic backdrop, it might seem strange that we have added two resource companies into the portfolio over the quarter. However, both these companies have very attractive positions within their own niche industries and both are significantly undervalued. The first is an emerging and significant mineral sands company, **Strandline Resources (STA)**. The company is in the final stages of constructing its Coburn mining and processing project near Geraldton in WA. Mineral sands prices have been strong over the past year or two but it remains a contract based market rather than a traded spot market and have also been less volatile than many other commodities. Demand for mineral sands is sensitive to the Chinese construction and building industries (pigments, ceramics and strategic metals). Global supply is dominated by a small number of global operators and there have been very few new projects commissioned in recent years meaning the market is tight. Coburn is significant in size, but not enough to alter the global balance. The project will be generating cashflow early in 2023 and is on time, on budget and fully funded. We see over 100% upside to the current share price based on a conservative outlook for mineral sands prices.

Liontown Resources (LTR) is an emerging hard-rock lithium miner based in the goldfields region of WA. We have been following the company's progress for some time and while the resource was clearly large and of high quality, the company still needed funding, offtake agreements, and most importantly for us, Final Investment Decision (FID) from the board. In December 2021 the company raised $490m in equity to partially fund the Kathleen Valley project and had signed offtake agreements with both LG and Tesla (obviously tier one customers). However, it was a $300m modestly priced debt facility and offtake agreement with Ford announced in June that has brought the project to full funding to production and completed underwriting the volumes scheduled for stage 1. The opportunity to invest presented itself following the FID announcement. The stock had retraced 35% from its December issue price and 50% from its high in April but with a significantly better and lower risk outlook.

At the end of the quarter, we had 39 stocks in the portfolio and were holding 3.6% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Beach Energy	Adairs	AUB Group
Codan	City Chic Collective	Codan
Earlypay	EML Payments	Elders
Elders	Silver Lake Resources	Service Stream
Evolve Education	Wisr	Shine Justice

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 30th June 2022. Top 5 positions are effective 30th June 2022.

Stock in Focus: PeopleIn (PPE)

PeopleIn (PPE) is Australia's largest end-to-end workforce solutions company, with services including recruitment, training, rostering and payroll. The company is diverse geographically and across sectors, many of which are defensive in nature including Health, Food Services, and Government, while exposure to the Technology sector is also meaningful and currently exposed to strong tailwinds. The revenue model is typically PPE earning a margin of 10-20% of wages paid to the contracted workforce. PPE has +550 staff across +25 brands, located in +30 locations, while servicing +3.5k clients with a candidate pool of +50k. The business was founded in 1996 and listed in 2017 and has delivered solid organic growth in that time, while supplementing this with earnings accretive acquisitions (14 since IPO) which has added to scale.

Investment Case Key Questions

1. **Growth Opportunity:** PPE's growth strategy is twofold: 1. Organic growth which we estimate to be 6-8% p.a. through a combination of further penetration of work within existing clients, new client wins, and wage inflation; and 2. Acquisitive growth, several of which have been made since IPO which have been earnings accretive; the workforce management services sector is highly fragmented so many opportunities exist. The company has delivered EPS growth of ~16% p.a. in the three years to FY21; we expect a similar level of growth in FY22 and a higher level of growth in FY23 given recent acquisitions (including the company's largest acquisition to date of Food Industry People in June 2022 which is expected to be +15% earnings per share accretive).

2. **Management:** while founders Declan Sherman and Tom Reardon hold substantial stock and remain involved in the business with executive and board duties, relatively new CEO Ross Thompson commenced in October 2021 and has impressed to date. He has held senior executive roles in UK listed professional services firm RPS and ASX listed engineering and environmental services firm Cardno, and has a track record of delivering sustained growth, having acquired and integrated numerous people focused businesses over his career.

3. **Financial Strength:** the company is modestly geared following the most recent acquisition of Food Industry People at 1.1x net debt/EBITDA, with a target gearing level of no greater than 1.5x. The company has periodically raised equity to fund its acquisitions, which have financially made sense given the earnings accretive nature of these acquisitions, and the company generates strong cashflows through its operations (90-100% cashflow conversion typically). This also allows PPE to pay a good dividend, which currently yields 5.5%.

4. **Risks:** the company is exposed primarily to Australian employment markets, so a protracted economic downturn is a risk to earnings; however, we would note the current 3.9% unemployment rate is close to a 50-year low. Integration risk given acquisitions are a core part of the company's growth strategy.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $5.13/s, reflecting upside of >80%. The stock is currently trading at a steep discount to the market, which is unwarranted given its earnings certainty (particularly in this environment), high earnings growth, above market ROE, and solid dividend yield.

Why now might be the time to consider an allocation to Small Caps

We've recently produced some research highlighting that Australian small companies are currently sitting at a relative valuation discount to large Australian companies. We feel that this process is overdone and now is the time to re-balance portfolios towards small caps. And in an environment of rising interest rates where free money is a thing of the past, the focus more than ever should be on investing in companies with growing earnings that are attractively priced. Please see here for the full report, or visit our website (under News & Reports → Research Insights).